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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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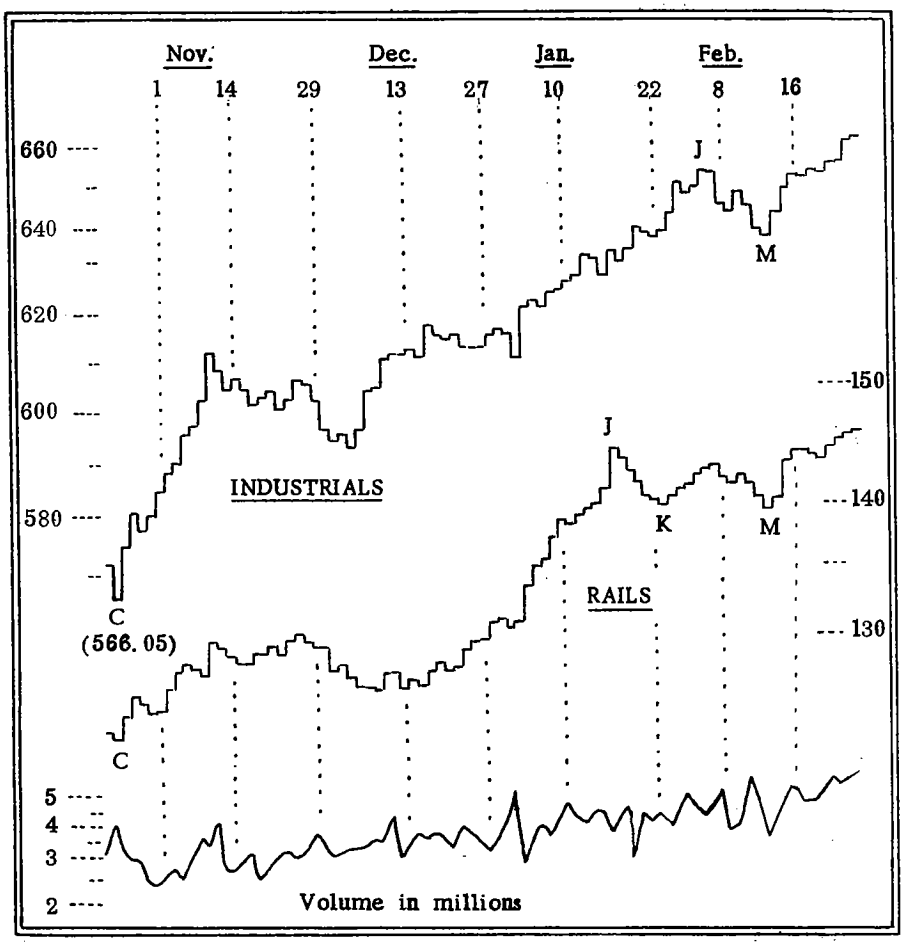
THE MARKET In April, 1959 (see chart, page 2) the "breadth" of the market (advance-decline ratio) turned down in what was to be the start of an eighteen month decline. That same month both Barron's and Standard & Poor's Low-Priced Stock Indexes "topped" and began extended declines which lasted to October, 1960. In July, 1959, the D-J Industrial and Rail Averages recorded their last confirmed highs and started down. That downturn continued to September, 1960, the point at which the bear market registered its last confirmed lows.

The bear market has been unorthodox in many ways. It did not have three phases; certainly the usual third phase (low volume, extremely depressed psychology) was not apparent. Prices during September and October, 1960, did not go "below known values", and with the exception of certain groups (machinery, oils, coppers, rails, farm equipment, etc.) stocks resisted drastic declines. Yields (as measured by the D-J Industrials held in an historically low area, and there was no period of greatly diminished volume (a phenomenon usually associated with bear market bottoms).

Nevertheless, a bear signal was given in March, 1960, and the bear market was reconfirmed by the joint penetration and new lows of September, 1960. In considering the validity of the bear signal in March, it was my opinion that all the characteristics which normally identify a bull market top had appeared in 1959. Yields had receded to extreme lows, low-priced stocks had spurted, public speculation was rampant, and volume was high (although many thought that it should have been higher).



In September, 1960, the two Averages recorded lows. Following a short rally, the Averages again turned down, and it was here that Industrials touched another new low unconfirmed by Rails. This non-confirmation proved to be the turning point from which the current advance developed.

On February 27 Industrials bettered their preceding secondary high of 656.42 (recorded in June, 1960). Thus one half of a bull signal was given. Under Dow Theory, however, half a signal is no better than none. On February 28 both Averages worked slightly higher to the accompaniment of huge volume (5.83 million shares). Although Rails bettered the critical 146.56 on an interday basis, the

final figures showed the Rail closing to be 146.01. This put Rails still 55¢ short of their March, 1960, secondary high and (incredibly) at the exact price registered at the June rally peak (146.01).

As this Letter is written (12 P.M., March 1) both Averages have retreated and Rails are now below the 145 level. If Rails persistently refuse to better the 146.56 point, the current price structure will appear increasingly dangerous. Conversely, if the 146.56 point is shortly bettered the evidence will strongly suggest that the primary trend has turned bullish.

In the great majority of cases bull markets have been signalled by the following series of events: (1) an advance of three weeks or more, (2) a full correction with one or both Averages holding above the preceding lows, (3) another advance which carries both Averages above the preceding highs. This structure was outlined in detail in Figure 1, Letter 133. If the current advance continues straight through the secondary highs we will then have witnessed the pattern described in Figure 2, Letter 133. In that event the evidence (although less satisfactory) would still point to the primary trend having turned bullish. Nevertheless, in the absence of the more orthodox primary reversal pattern and in the absence of more convincing evidence of a preceding bear market bottom, it is the opinion of this writer that final verification of the turn from bear to bull market would require a bettering of the previous bull market highs (685.47 and 173.56).

"MARKET BREADTH" (Advance-Decline Ratio) I have referred to the relationship of the Averages and breadth with increasing frequency over the last few months. On February 27 the price-breadth relationship provided part of an important technical confirmation (see Letter 131).

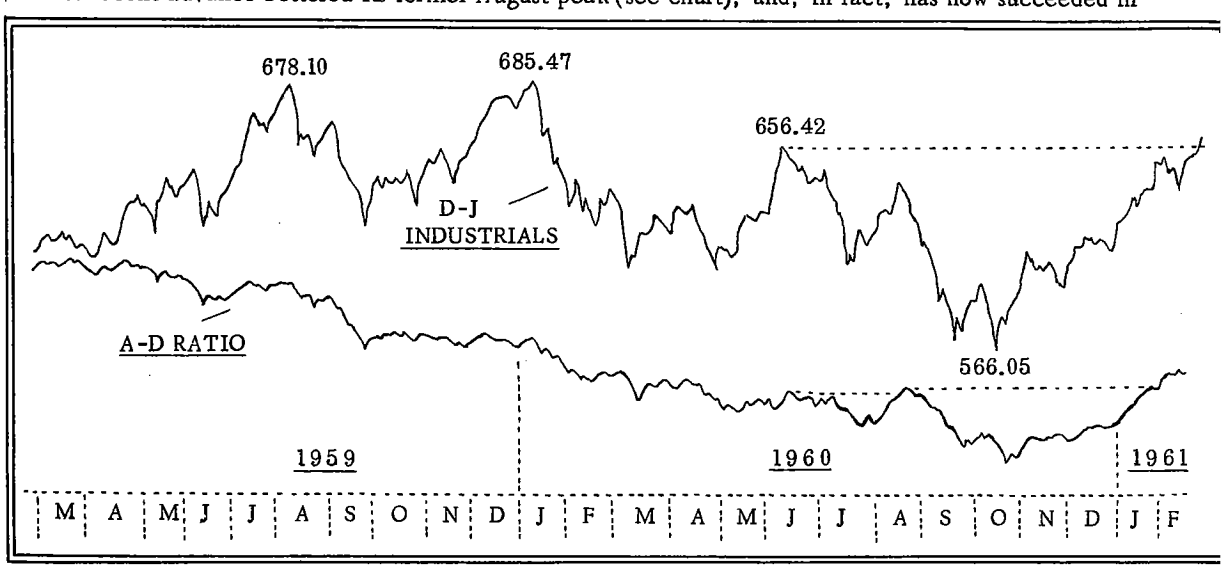
Normally, the A-D Ratio should move "in gear" with the Averages. For this reason the market student is constantly on the alert for two possible adverse indications in the breadth-price relationship; (1) divergence, and (2) non-confirmation. The first is the more obvious, and one often hears analysts discussing the fact that the Averages advanced while more issues declined than advanced or vice versa.

When divergence between price and breadth continues over an extended period (three weeks or more) it is safe to say that a vacuum is being formed, and that something is amiss in the market. The accompanying chart shows the A-D Ratio touching a 1959 high in April, then embarking on an almost unabated eighteen month decline. Despite the steady retreat of breadth, Industrials rose to historic peaks in August, 1959 (678.10), and again in January, 1960 (685.47). The vacuum created by the persistent divergence between price and breadth proved too strong in each instance, however, and this led to the broad declines of August-September, 1959, and January-October, 1960

A most interesting case of non-confirmation occurred in August, 1960. Here the A-D Ratio bettered a previous peak for the first time in sixteen months, but Industrials stopped 12.86 points short of the preceding June peak (656.42). This non-confirmation gave way to the 75 point Industrial drop to the October, 1960 low of 566.05.

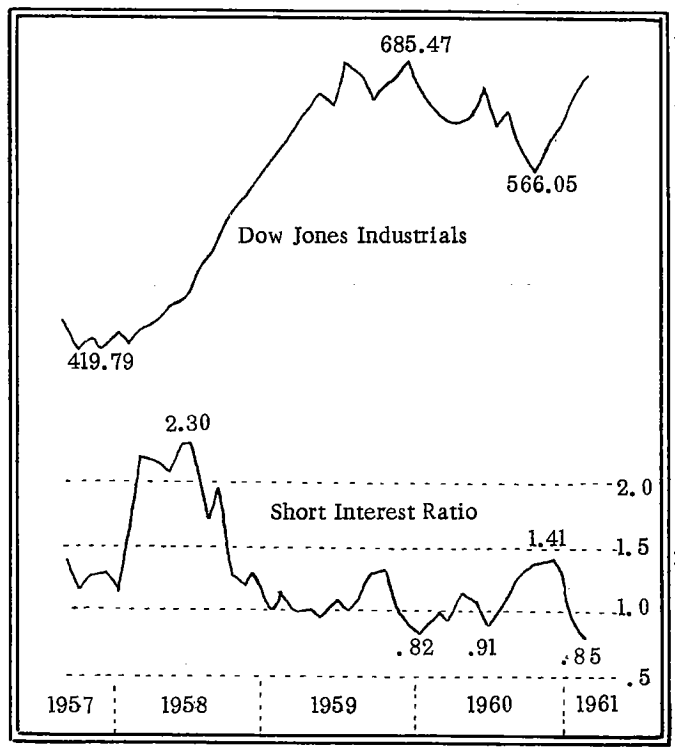
Following the 566.05 bear market low, Industrials and the A-D Ratio again rose sharply. As pointed out in Letter 131 (January 25, 1961) the A-D Ratio on its most recent advance bettered its former August peak (see chart), and, in fact, has now succeeded in climbing to its highest level since January, 1960.

On February 27 Industrials finally hurdled the June, 1960 peak of 656.42; in so doing Industrials confirmed the earlier indications of breadth (see chart). It remains for Rails to close the vacuum with a bettering of the 146.56 point.



SHORT-INTEREST RATIO (S.I. Ratio) The S.I. Ratio (last discussed in Letter 131) is now in an area where it bears the closest watching. Among the various "psychology of the market" studies, I consider the S.I. Ratio to be one of the really important indicators of an "over-bought" or "over-sold" market. As is the case with all other market tools, however, the S.I. Ratio must be read as one reads a barometer. A barometer may point to "stormy weather ahead", and the storm may not materialize or it may miss the ship entirely. Nevertheless, the storm elements were there, and the experienced navigator will not smash the barometer because that instrument lacked infallibility or pinpoint accuracy at a given time.

Since 1949 there have been only four instances when the S.I. Ratio dropped to new lows on three successive months. During July-October, 1951, the S.I. Ratio dropped from 1.75 to 1.56. The market reacted from September through November, 1951 (the Korean "peace rumors" and the "higher taxes scare" were held responsible). From February to April, 1953, the S.I. Ratio dropped from 1.05 to .92. This corresponded with the market decline which lasted from January to September, 1953. From September, 1954 to January, 1955, the S.I. Ratio dropped from 1.61 to .74, and this period must be put down as a "storm that blew itself out". The market suffered only a mild setback in March of 1955, then headed sharply higher. From October, 1959, to January, 1960, the S.I. Ratio dropped from 1.32 to .82, and the resultant collapse is recent history.



In November, 1960, the S.I. Ratio recorded a high of 1.41. Three consecutive declines since then have taken the indicator to a February, 1961 low of .85. Thus the "storm flag" is again being hoisted, and this should serve to bridle the enthusiasm of those who follow the technical picture. It should be noted, however, that the recent drop in the S.I. Ratio was caused largely by the tremendous average daily volume of trading over the last month. Thus a further market rise on continued huge volume would point to an even lower figure on the S.I. Ratio, while a retreat on diminishing volume would in all likelihood erase the string of consecutively lower readings on the Ratio.

Note: we still have copies of Letter 131 (which explains the S.I. Ratio in more detail, and subscribers who would like copies should send a stamped, self-addressed envelope.

QUESTION "Your Letter No. 133 has arrived and has aroused my greatest interest. I refer to your discussion of primary changes. On page 2 you say that "Rhea accepted the formation in Figure 2 as implying a change in the primary direction." This is what I have used and called the 100% rule for the last five years, but though I had strong suspicions that this was accepted by some Dow Theorists in America, I had never been able to get convincing evidence to support this. I would appreciate it very much indeed if you could let me know where in Rhea's writings you are of the opinion that he accepted this rule." (J.F.D. Essex, England)

ANSWER The last secondary reaction in the 1929-32 bear market established highs on March 8, 1932. From that point both Averages turned down and broke all previous lows, recording a final bottom on July 8, 1932. From those drastic lows, one of the most spectacular rallies in market history ensued. Commenting on the situation, Rhea wrote (November 12): "Those who consider the July lows as the end of the bear market are not discouraged because the July-September advance did not carry through the first quarter's (March 8) highs, which action would have confirmed a bull market."

This interpretation was amplified in an article which Rhea wrote for Barron's that year: "When declines in a primary bull market result in violating the lowest points encountered during the last major secondary reaction of that market, it may generally be assumed that the primary trend has changed from bullish to bearish; the converse, of course, is usually a dependable means of determining when a bear primary movement has changed to the beginning of a bull market."

STOCKS Barron's Low-Priced Stock Index dropped from a high of 250 in April, 1959 to a low of 162 in October, 1960. Since then the Index has crept higher, but as of last week it had only recovered to 190. One of the stocks in the Barron's Index is Avco Mfg. Co. The weekly chart shows what appears to be a "triple top" in Avco. It is obvious that the 17 area represents a formidable area of resistance for this stock, and technicians might be inclined to trade the stock in one of the following ways: (1) buy it on a possible dip to the consolidation area around 13-14, or (2) buy it on a "breakout" above 17 1/2 providing that breakout is accompanied by impressive volume. It is a hopeful indication that each of the three bottoms since 1959 came at progressively higher levels.

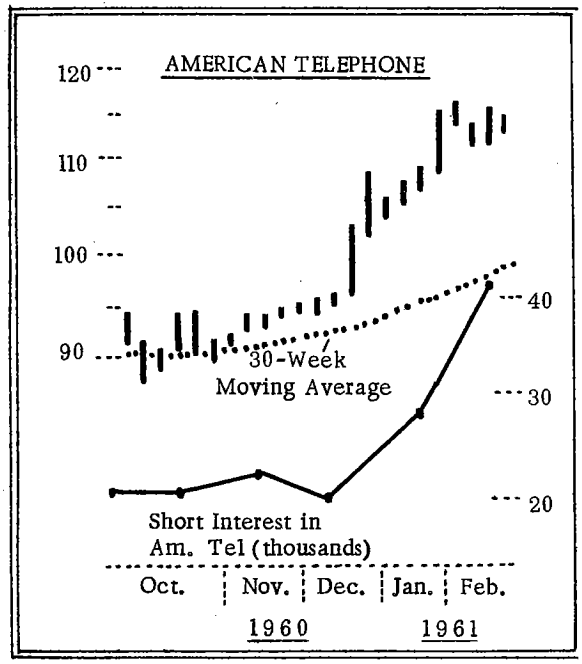
The chart shows the bear market collapse in J. I. Case, a leading maker of farm equipment. Even if the stock has "topped out" for many years to come, it would not be surprising to see it "pull back" to its general area of supply at around 17. Often corrections of collapses such as the one in Case can be violent and seemingly quite powerful.

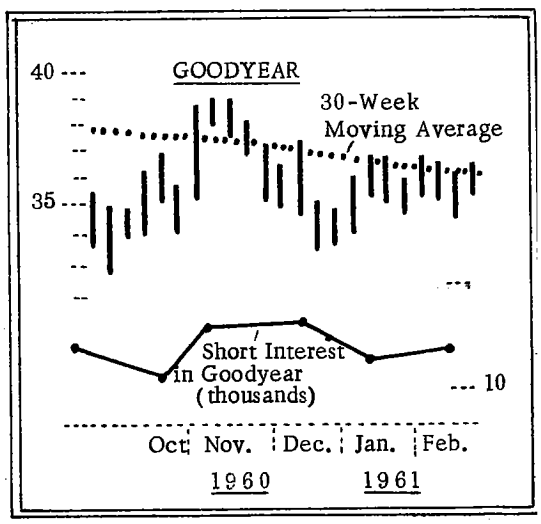
Continuing last week's comments regarding stocks and their relationship to their own 30-week moving averages and short interest positions, I have included a chart of American Telephone, the most widely-held stock in the nation. The chart shows "T" rising decisively above its moving average in November, 1960, and more recently spurting 16 points above the moving average. It is interesting to note that the short interest in T tripled during the last three months, and this demonstrates the general disbelief which accompanied the advance. Technically, the fact that T advanced above its moving average and shorts were gathered on the move must be viewed constructively. Past experience suggests, however, that when a stock moves too far above its moving average it becomes overdue for a correction (which should hold above a rising moving average line).

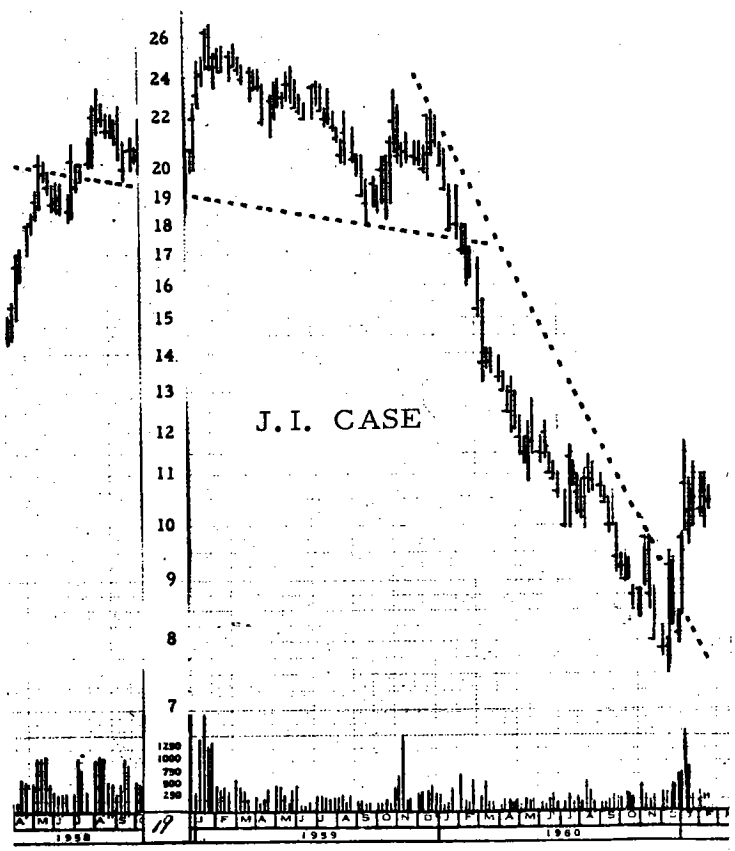
Goodyear has just bettered its 30-week moving average, and the short interest in this stock has held about level over the last six months. The stock must be considered to be in an upward trend.

TACTICS If, on a decline, one or both Averages can hold above the preceding lows at M (Industrials -637.04, Rails - 139.68) as volume dries up, speculative purchases could be made on the assumption that the next advance will approach or better the highs. The following "package" might be purchased: Goodyear, Int. Paper, Sears Roebuck, Anaconda, U. S. Steel, N. Y. Central.

(Written: Wednesday, March 1st - 12 P. M.)







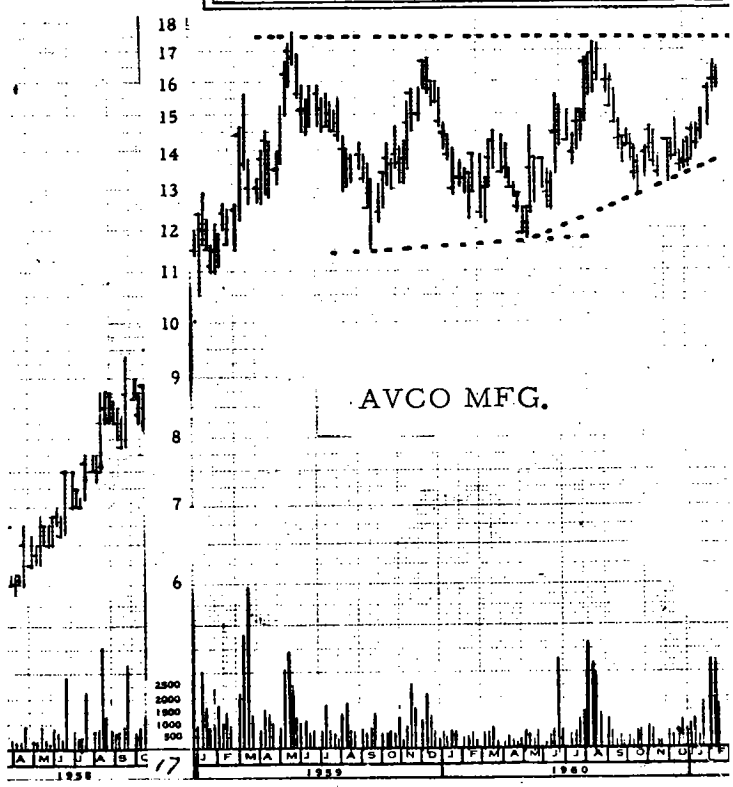


Chart of Avco and Case curtesy of Traders Research, Box 6185, Lambert Airport, Missouri.